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C O N F I D E N T I A L SECTION 01 OF 02 KARACHI 000361

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SUBJECT: KARACHI STOCK EXCHANGE - REFORMS, HOPES, CHALLENGES

Classified by: Consul General Stephen G. Fakan, Reasons 1.4 (b)and (d)

¶1. (C) Summary: In the wake of Pakistan's 2008 financial collapse, the Karachi Stock Exchange (KSE) is introducing viable leverage products and debt liquidity, implementing stringent safeguards against market manipulation, and pursuing demutualization - through decoupling exchange ownership and trading rights. KSE and Security and Exchange Commission officials told Econ Offs these reforms will establish a more stable and modern trading platform, capable of attracting both foreign and domestic investment. Despite these officials' optimism, institutional malaise, cronyism, and a lack of political will threaten to impede reform efforts. End summary.

2008 Market Collapse

¶2. (U) Pakistan's 2008 economic collapse had a significant impact on the Karachi Stock Exchange (KSE), with total market capitalization plummeting from a high of $78 billion in 2007 to approximately $33 billion today. Daily trading activity also dropped from $500-600 million to approximately $300 million over the same period. From August to December 2008, the government imposed a floor on KSE to prevent further declines. However, the market has shown recent signs of recovery, with increased trading volume and a positive trend in portfolio investment. There are also several initiatives underway that have investors and the KSE management optimistic about the future of the exchange.

Demutualization is Coming

¶3. (SBU) On October 13, Adnan Afridi, Managing Director of the KSE, told Econ Offs that "demutualization, through decoupling the broker's ownership of the exchange from their trading rights, is the key to modernizing the capital markets." (Note: Demutualization is the process by which a customer-owned mutual organization or co-operative changes legal form to a joint stock company. End note.) Afridi believes demutualization will increase both market transparency and efficiency, and will inject much needed capital into the KSE.

¶4. (C) The first step, diversification of the KSE Board of Directors, was implemented in 2007 to counter claims that the KSE was operating as a monopoly and that the 200 brokers, who both own and have exclusive trading rights on the exchange, were blatantly manipulating the market. An independent chairman and managing director were appointed to guide day-to-day operations of the exchange and independent businessmen were given seats on the Board to help balance the interests of the brokers. However, according to Mateenullah Khan, Joint Director for the Securities Market Division (South) of

the Securities & Exchange Commission of Pakistan (SECP), changes to the Board have not been fully effective in preventing cronyism and manipulation, as many brokers retain close relationships with the independent members of the Board and are able to either influence or outmaneuver them when disagreements arise.

¶5. (U) On October 11, the National Assembly passed a bill that would finish the process of demutualization. Under the provisions of the bill, the 200 brokers who currently own the KSE would sell 40 percent of their equity to "strategic international partners" and an additional 20 percent to private investors, leaving the brokers with a 40 percent ownership stake. The bill must still pass the Senate before it becomes law, and the changes implemented.

Return of Margin Trading

¶6. (U) Plans developed jointly by the KSE and the SECP in accordance with international standards and best practices to re-introduce margin trading, suspended in 2008 due to its perceived role in contributing to the market crash, are moving ahead. Unlike the Badla system (an indigenous "carry-forward" finance system where brokers were the sole financers) the new system would standardize broker requirements and allow non-broker entities, such as banks, to provide leverage financing. The proposal also includes safeguards such as equity requirements, "circuit breakers" (designed to prevent the collapse of securities), and an online investor tracking system to limit fraud. The SEC has approved this system which is expected to be fully implemented within the next six months.

Happier Days Ahead?

¶7. (SBU) Arif Habib, former chairman of the KSE and CEO of one of Karachi's largest investment banks, believes Initial Public Offerings (IPOs) will play a major role in future market capitalization. In the past, IPOs were not seen as viable because of the loose lending standards and low interest rates offered by banks. However, following the 2008 financial crisis, banks have tightened lending requirements, reducing the sources of cheap debt, and increasing the competitiveness of IPOs. Habib expects that in FY 2009-2010 there will be between 15 to 20 IPOs, compared with zero during the FY 2008-2009. (Note: There have been three successful IPOs thus far this year, and four more are in process. End note.) The KSE is also planning an aggressive outreach campaign to the largest 100 companies in Pakistan to urge them to use private financing and to convince the government to divest more of their 27 percent market share.

¶8. (SBU) On November 2, the KSE launched its Bond Automated Trading System (BATS). This introduced the trading of debt market securities to Pakistan's exchanges. According to Anita Mirza, KSE Head of Marketing, the new system is being well received by brokers. During the first day of trading, Rs 40 million ($500,000) of transactions for term finance certificates from 24 companies were conducted. Mirza described the day as "very successful," and said the value and number of transactions, and companies, will increase as the market develops.

Comment

¶9. (C) Despite optimism regarding these ongoing reforms, many threats remain to the long-term viability of Pakistan's financial system. While portfolio investment has stabilized, foreign direct investment remains well below 2007 levels. Afridi cited a lack of investor and broker knowledge of the current market and proposed enhancements, stating that such institutional malaise threatens reform efforts. Meanwhile, Khan expressed concern over Pakistan's antiquated legal framework and a lack of political will to implement needed reforms. Finally, terrorism, with its debilitating impact on the market's stability, remains a significant unknown to the future viability of the KSE.

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